

**Hexo Corp.
HYYDF
Investment Notes**

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HEXO is an adult-use cannabis brand based in Gatineau, Quebec. They claim to focus on innovative, smoke-free and traditional cannabis products.

HEXO claims their products are grown and processed in state-of-the-art facilities at their campus in Masson-Angers, Quebec, about 30 minutes from Ottawa.

Fiscal year end is July.

All dollar values are in Canadian currency, unless otherwise stated!

July 29, 2019 (\$4.06) We increased our position on July 26, 2019 by slightly over 100% at \$4.06 per share, to bring it to a ~1% holding for most accounts. Our average cost is now \$4.51 per share.

2-Minute Drill and Thesis:

308M fully diluted shares, leads to a market capitalization of \$1.25B. Using a somewhat arbitrary estimate of \$450M CAD for F2021 projected revenues, and the current conversion rate of .76, the projected revenues in USD would be \$342M USD. Hence the valuation is 3.65X these F2021 projected revenues. The mean estimate as of this writing for F2021 is \$504.58M CAD. The median is \$523.61M CAD. The lowest F2021 revenue estimate is \$305.50M CAD, and the highest is \$632.68M CAD.

We are not overly concerned with revenue estimates, and potential “misses,” as we are looking to invest in a company that can generate revenues in the area of \$1B CAD with regularity sometime this decade, and we would expect that prior to F2026.

Very risky cannabis company, which as with all the Canadian licensed producers carries great risk of both valuation and execution. They have a JV with Molson Coors Canada which is interesting. Potential F2021 revenues (7/31/21) of \$450M CAD. Management seems capable and honest. Hexo is known as a top-tier vertically integrated Canadian cannabis company, and based on the recent price drop, especially from our trimming of our investment during September 2018 at \$6.72, we decided to increase our ownership to be a more meaningful portfolio position. Management seems capable and honest. Our thesis is basically a pure play cannabis investment, with a company that will potentially grow their revenues to commensurate their current market capitalization of \$1.25B USD. At this point financial statement analysis and projections are rather meaningless. We must wait and see if they can increase revenues in a meaningful fashion, of their vertically integrated operation.

Some other concerns, which if happens would possibly hurt the stock price short-term but shouldn't have any permanent effect on this company or any Canadian cannabis company would be, the potential of revenue misses because of new Canadian excise tax laws, as well as the potential for inventory and biological asset impairments. There is also some recent discussion of Quebec being concerned of edibles becoming legal, as they could be enticements for usage by minors.

Officers and directors own ~8.78% of fully diluted shares outstanding. I like seeing management have skin in the game, as often their interests are aligned with shareholders'. I haven't seen any insider sales, other than what appeared to be option sales by Director, Nathalie Bourque of 41,668 shares which she received and sold on May 13, 2019 at ~\$6.75 USD.

On the negative side, I find the officer's compensation to be rather excessive.

Summary Compensation Table

The following table sets out the compensation for the Corporation's Named Executive Officers for the years ended July 31, 2018, July 31, 2017 and July 31, 2016:

Name and Principal Position	Fiscal Year	Salary (\$) ⁽⁹⁾	Share-Based Awards (\$)	Option-Based Awards (\$) ⁽⁷⁾	Non-Equity Incentive Plan Compensation (\$)		Pension Value (\$)	All Other Compensation (\$) ⁽⁸⁾	Total Compensation (\$)
					Annual Incentive Plans	Long-Term Incentive Plans			
Sebastien St-Louis ⁽¹⁾⁽²⁾ <i>Chief Executive Officer</i>	2018	\$327,308	Nil	\$1,180,254	Nil	Nil	Nil	\$30,691	\$1,521,332
	2017	\$177,209	Nil	\$191,875	Nil	Nil	Nil	\$6,522	\$375,606
	2016	\$125,000	Nil	Nil	Nil	Nil	Nil	Nil	\$125,000
Ed Chaplin ⁽¹⁾⁽³⁾ <i>Chief Financial Officer</i>	2018	\$259,952	Nil	\$322,493	\$18,750	Nil	Nil	Nil	\$601,195
	2017	\$153,211	Nil	Nil	\$118,750	Nil	Nil	Nil	\$271,961
	2016	\$125,000	Nil	\$181,722	Nil	Nil	Nil	Nil	\$306,722
Adam Miron ⁽¹⁾⁽⁴⁾ <i>Chief Brand Officer</i>	2018	\$254,846	Nil	\$229,331	\$22,500	Nil	Nil	\$32,230	\$556,177
	2017	\$135,363	Nil	Nil	\$22,500	Nil	Nil	\$6,522	\$164,385
	2016	\$125,000	Nil	Nil	Nil	Nil	Nil	Nil	\$125,000
James McMillan ⁽¹⁾⁽⁵⁾ <i>Vice-President, Business Development</i>	2018	\$175,576	Nil	\$81,512	\$150,000	Nil	Nil	Nil	\$407,088
	2017	\$135,000	Nil	\$96,751	\$48,941	Nil	Nil	Nil	\$280,692
	2016	\$135,000	Nil	Nil	\$24,017	Nil	Nil	Nil	\$159,017
Terry Lake ⁽⁶⁾ <i>Vice-President, Corporate Social Responsibility</i>	2018	\$233,285	Nil	\$203,838	Nil	Nil	Nil	Nil	\$437,123
	2017	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil
	2016	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil

They do not have a big 4 auditor. I like to see a company commitment to quality with a Big 4 auditor. The auditors are a large recognized firm, of MNP LLP. From what I have seen, MNP LLP appears to be the common auditor of many of the Canadian cannabis companies.

As in all our cannabis research, we expect eventual world-wide legalization of cannabis, like the alcohol industry today. Canada is the first G-7 nation to legalize cannabis, and we expect other G-7's to follow suit, including the USA.

Again, this is a speculative investment, in a speculative industry, and cannabis is Federally illegal in the USA. The company could have execution risks, which are also inherent in the industry. The industry is in its infant stages, and there could be several catalysts to increase the share price over time. These catalysts could include legalization in the USA, changes in laws of a Canadian company selling to States in the USA, greater acceptance of cannabis as a long-term future industry in the USA and the world.

Other Notes:

308M fully diluted shares, leads to a market capitalization of \$1.25B. Using Merrill's estimate of \$489M CAD for F2021 projected revenues, and the current conversion rate of .76, the projected revenues in USD would be \$371.6M USD. Hence the valuation is 3.36X these F2021 projected revenues. This revenue projection was updated on July 29, 2019, the previous estimate was \$545M

CAD, in a report issued on June 13, 2019. We are not concerned, as we are looking to invest in a company that can generate in the area of \$1B CAD with regularity sometime this decade, and we would expect that prior to F2026.

Seaport Global in a report dated June 14, 2019, projects F2021 revenues of \$613M CAD.

CIBC in a report dated June 14, 2019, projects F2021 revenues of \$450.5M CAD.

A healthy balance sheet as of 9 months ended April 30, 2019. Cash of \$173M. Inventory of \$37M. Biological assets of \$12M. Current assets \$266.5M, and Current liabilities of \$47.4M. Shareholders' equity of \$433M.

Gross revenues for 3Q19 were \$15.9M, net revenues of \$12.96M.

“HEXO most recently announced the closing of the agreement to acquire Newstrike. The acquisition will provide HEXO Corp capacity to produce approximately 150,000 kg of high-quality cannabis annually with access to four additional production campuses. It also provides the Company diversified domestic market penetration with combined distribution agreements in eight provinces. The combined entity is estimated to realize millions in annual synergies, allowing HEXO to operate more efficiently with a continued commitment to excellence.”

April 17, 2019 (\$6.43) Merrill initiates a buy and a \$10 USD target, stock up ~8%

“HEXO is our top pick in cannabis, as it is compelling on valuation vs peers (as we discuss), and with fundamentals grounded by the most de-risked cannabis supply in Canada (off-take with Quebec), an innovation-forward organization and potential for additional value-add partnerships (beyond that already developed with Molson Canada).”

They project revenues of \$64M CAD for 2019, \$318M CAD for 2020, \$565M for 2021, and \$751M CAD for 2022. They project eps of (\$0.17) CAD for 2019, \$(0.20) CAD for 2020, \$0.11 CAD for 2021, and \$0.44 for F2022.

March 14, 2019 (\$6.13) 2- Minute Drill

Very risky cannabis company, which as with all the Canadian licensed producers carries great risk of both valuation and execution. They have a JV with Molson Coors Canada which is interesting. Potential F2021 revenues (7/31/21) of \$653M CAD. Management seems capable and honest. Yet, this is high risk, and this is in line with our small position of ~0.32% of a portfolio. The position was larger, yet we trimmed at \$6.72 on September 18, 2018.

March 14, 2019 (\$6.08) 2Q19 Results released 6-Months ended January 31, 2019

Valuation based on 261M fully diluted shares outstanding is ~\$1.6B USD. F2021 projected revenues by one analyst are \$653M CAD, using the current conversion rate of .7505, the projected revenues in USD would be \$490M USD. Hence the valuation is 3.27X these F2021 projected revenues.

Income Statement Snapshot	For the three months ended		For the six months ended	
	January 31, 2019	January 31, 2018	January 31, 2019	January 31, 2018
	\$	\$	\$	\$
Gross cannabis revenue	16,179	1,182	22,809	2,283
Excise taxes	(2,803)	–	(3,817)	–
Net revenue from sale of goods	13,376	1,182	18,992	2,283
Ancillary revenue	62	–	109	–
Gross margin before fair value adjustments	6,939	731	9,772	1,369
Gross margin	11,603	752	18,842	3,215
Operating expenses	18,486	5,491	40,524	8,335
Loss from operations	(6,883)	(4,739)	(21,682)	(5,120)
Other income/(expenses)	2,558	(4,213)	4,553	(5,750)
Net loss	(4,325)	(8,952)	(17,129)	(10,870)

Operational Results	For the three months ended	
	January 31, 2019	October 31, 2018
Average selling price of adult-use dried gram & gram equivalents	\$ 5.83	\$ 5.45
Kilograms sold of adult-use dried gram & gram equivalents	2,537	952
Average selling price of medical dried gram & gram equivalents	\$ 9.15	\$ 9.12
Kilograms sold of medical dried gram & gram equivalents	152	158
Total kilograms produced of dried gram equivalents	4,938	3,550

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Kilograms sold of adult-use dried gram & gram equivalents	2,537	952
Average selling price of medical dried gram & gram equivalents	\$ 9.15	\$ 9.12
Kilograms sold of medical dried gram & gram equivalents	152	158
Total kilograms produced of dried gram equivalents	4,938	3,550

Oils sales represented 23% of the adult-use revenues.

In December 2018, they “reached a construction and licensing milestone with the first zone of the 1,000,000 sq. ft. greenhouse expansion. This goal was met within the first year of its announcement, on time and on budget. This milestone is an important first step as the Company continues ramping up to an annual production capacity of 108,000 kg of dried cannabis.”

\$165M in cash and equivalents.

Inventory of \$21M, Biological assets of \$4.2M.

Investment in JV’s of \$49M. This is primarily the formation of the joint venture **Truss** between the Company and Molson Coors Canada.

Current assets of \$247.7M, Current liabilities of \$23.4M.

Shareholder equity of \$423,195M, and Tangible equity of \$418,337M.

Weighted average shares outstanding of 198.3M.

Total shares of common, warrants and options were 261,001,999 on March 13, 2019.

On March 12, 2019 HEXO agreed to acquire Newstrike Brands Ltd. *“The Transaction gives HEXO the capacity to produce approximately 150,000 kg of high-quality cannabis annually. The Transaction also provides HEXO access to four cutting-edge production campuses totaling close to 1.8 million sq. ft. of near-term cultivation space and diversified growing and production techniques. This is in addition to HEXO’s 579,000 sq. ft. facility for a manufacturing and product development centre of excellence in Belleville, Ontario.”*

In a report dated March 14, 2019, PI Financial projects FY19, FY20, and FY21 sales forecasts of \$59.4M, \$400M, and \$665M respectively (previously \$90.1M, \$401M, and \$653M). They project FY19, FY20, and FY21 eps forecasts of (\$0.07), \$0.31, and \$0.45 respectively.

February 20, 2019 (\$5.91) CIBC issues Outperform rating (Target of \$8.50 CDN, which converts to \$6.46 USD using current currency conversion of 76%.)

“We believe one name that presents investors with a greater element of safety in a cannabis industry plagued by uncertainty and risk is HEXO Corp. A landmark deal with Quebec’s wholesale buyer, paired with a partnership with one of the largest beverage companies in North America, and a knack for innovative product design help distinguish HEXO from many of its peers. Its balance sheet and pedigree of senior management may not match some other competitors, but we believe reasonable upside exists with a much higher floor than most other producers in the cannabis space.

As of February 19, we initiate coverage of HEXO Corp. with an Outperformer rating and an \$8.50 price target.”

Income Statement	F 2019E	F 2020E	F 2021E
Production Capacity (MM sq. ft)	13	19	19
Production Capacity ('000 kg)	108	158	158
Kilograms Sold ('000)	15.0	41.0	63.8
Average Selling Price per gram	\$5.65	\$5.46	\$5.13
Total Revenues	83.7	223.9	327.2
Y/Y Growth %	1596%	167%	46%
Consensus Revenue (FactSet)	89.0	229.0	398.9

Claims *“Hexo is the flagship supplier for the Quebec market, which creates an opportunity for \$1billion in sales over a five-year period.”*

Cites partnership with Molson Coors Canada valuable to Hexo, as MCC brings valuable expertise in distribution and production.

September 18, 2018 (\$6.72) Reduced our position to 0.33% at \$6.72 per share. This is a gain of over 80% since our purchase in July.

As described below, this became too expensive, and I wanted to trim the position to be more in line with my investment thoughts. I will explore further sales if price keeps increasing, or if our thesis changes.

September 18, 2018 (\$6.76) I am using fully diluted shares outstanding of 246M (from August 2018 corporate presentation) for valuation purposes

SHARE CAPITALIZATION

Common Shares issued and outstanding (as at August 27, 2018)		
	193,629,116	
WARRANTS		
Warrants @ \$0.75	2,051,357	Mar'19 to Mar'22
Warrants @ \$0.83	3,334,982	Mar'19 to Oct'19
Warrants @ \$4.00	1,495,000	Jan'20
Warrants @ \$5.60	18,570,500	Jan'20
Warrants @ \$56.00*	11,500,000	est Sept'20
Warrants @ US\$0.70	45,143	Nov'19
Warrants @ US\$0.76	928,542	Nov'19
STOCK OPTIONS		
\$0.16 strike price	570,000	May'19
\$0.58 strike price	1,241,900	Nov'24 to July'25
\$0.75 strike price	2,248,996	Nov'24 to Jan'27
\$1.27 strike price	606,700	July'27
\$1.37 strike price	651,000	Sept'27
\$2.48 strike price	128,000	Nov'27
\$2.69 strike price	1,695,000	Dec'27
\$3.89 strike price	325,000	Mar'28
\$4.24 strike price	258,000	Jan'28
\$4.27 strike price	885,000	Apr'28
\$4.89 strike price	5,667,500	July'28
\$5.15 strike price	111,000	June'28
FULLY DILUTED SHARES	245,942,716	
MANAGEMENT AND BOARD OWNERSHIP (as at Apr. 30, 2018)		
	9.44%	

* Expected to be issued September 2018

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Market cap is \$1.66B USD.

Echelon uses projected revenues in F2018 of \$4.9M, F2019 of \$102.5M, and F2020 of \$367.2M. Price to F2020 estimated revenues of \$367.2M X CAD current conversion rate of 0.77 is 4.8X. This is considered fully valued to over-valued. Of course, as we have seen in many booms, forecasts not achieved, and valuations rampant to traditional value thoughts. My concern is the forecasts are too optimistic to begin with.

PI Financial uses projected revenues in F2018 of \$4.9M, F2019 of \$94.3M, and F2020 of \$232.9M. Price to F2020 estimated revenues of \$232.9M X CAD current conversion rate of 0.77 is 7.6X. If this is accurate, this is borderline absurd. Yet, perhaps F2022 revenues will be \$800M CAD, which could make the valuation more in line.

July 12, 2018 (\$3.70) Established a 1/3% position at \$3.70

Thesis is high risk, very speculative, just another cannabis name in the industry. Yet, projected F2020 revenues could be > \$300M USD, hence a P/S if attained of < 4X. I originally thought revenues could be \$600M USD, but I was pricing their price per gram too aggressively.

Upon further research it looks as though my revenue potentials are too high. This is probably based on selling price of \$6 per gram is about 50% too generous. I will re-evaluate and use \$3.32 USD per gram. Hence, F2020 estimated revenues I will use as a road map is \$332M.

July 11, 2018 (\$3.68)

Market cap is \$842.7M USD

108,000kg production targeted by end of 2018. This is 108M grams. Using a price of \$3.50 per gram, annual revenues could be \$378M USD. I originally had written \$6 per gram for \$648M USD. That was incorrect.

Fully Diluted Shares outstanding as of April 30, 2018

Common Shares Outstanding	179,889,233
Stock Options	9,407,396
Warrants	39,703,115
Total fully diluted shares outstanding	228,999,744

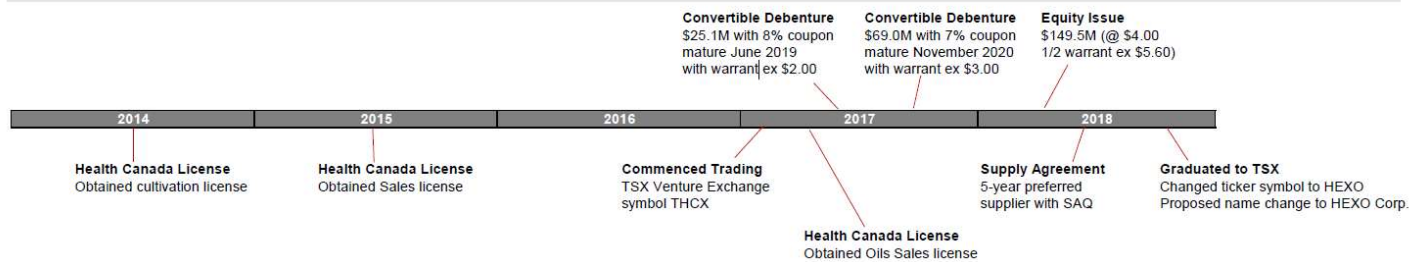
The following data is in CDN unless otherwise noted:

Book value is \$291.8M. Tangible book value is \$288.3M.

Inventory is \$9.2M. Biological assets is \$1.9M.

As of April 30, 2018, there were 137 employees. 23 were in cultivation and harvesting, 38 in operations, 40 in sales and marketing, 6 in quality assurance and research, and 30 in corporate.

Figure 1 - Timeline



Source: The Hydropothecary Corporation & PI Financial Corp.

Hydropothecary secured a massive long-term supply agreement with Quebec. They have a supply agreement with Quebec over a 5-year period to supply 200,000 kilograms. The expected production in the first year is 20,000 kilograms. Using \$3.50 USD per gram would generate \$700M over 5 years. If this occurs, there is a somewhat predictable cash flow stream.

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